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## Emerging Circuit Split Over Modification of Mortgages on Multi-use Real Properties

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# EMERGING CIRCUIT SPLIT OVER MODIFICATION OF MORTGAGES ON MULTI- USE REAL PROPERTIES

*Michal Zabadal\**

## ABSTRACT

For many decades, healthy levels of residential mortgage loans (“RMLs”) and their regulation have been among the major drivers of the economy. Because of the importance of RMLs for the condition of the national financial system and the general well-being of the society, it is essential that lenders are reasonably incentivized to originate these loans. A well-designed promise of higher recovery on RMLs in times of distress can be a compelling motivator. The Bankruptcy Code seeks to deliver on that promise by treating RMLs more favorably. It does that by barring the debtor-in-bankruptcy from modifying a claim secured by a mortgage on real property that represents the principal residence of the debtor.

The modification of a general secured claim may come in many flavors. Most potently, it can take the form of bifurcation of an under-secured claim into two portions: one, equal to the value of the property securing it; and second, for the remainder of the original claim. It is the second portion that will, following such bifurcation, be treated as an unsecured claim. As a result, the recovery on the unsecured portion will commonly be only cents on the dollar. Creditors whose RMLs are secured by the principal residence of the debtor enjoy protection from bifurcation, and, consequently, achieve higher recovery on their claims.

At first glance, the condition for the application of the anti-modification protection is straightforward—the claim must be

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\* J.D. Candidate, Fordham University School of Law, 2021; J.D., Charles University in Prague, School of Law, 2018. I would like to thank Professor Susan Block-Lieb for introducing me to the world of bankruptcy and for her invaluable insights and guidance throughout this Note. I would like to also thank the editors and staff of the *Fordham Journal of Corporate & Financial Law* for their help in the editing process. Finally, a special thank you to my wife Meagan and my family for all their support and encouragement throughout law school.

secured only by real property that is the principal residence of the debtor. Unfortunately, many complexities have arisen out of attempts to determine what constitutes one's principal residence in this context. Is any real property where the debtor principally resides the debtor's principal residence, even though the debtor simultaneously runs a business on the property or rents a portion of the property to a third party? Alternatively, does the debtor have to use the property exclusively as her principal residence for the claim to qualify for the anti-modification protection? Viewed from yet another perspective, does it matter whether the parties to a particular mortgage transaction intended to provide the debtor with a home or a source of income? As different courts embraced the question of what constitutes the debtor's principal residence differently, three distinct interpretive approaches arose.

This Note begins with a survey of the relevant interpretive approaches. It then advocates for the adoption of an approach that, in the author's opinion, best enables the Bankruptcy Code to deliver on its promise and to achieve the ultimate purpose of the anti-modification protection—encouraging the flow of capital into the RML market.

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## INTRODUCTION

In an economic crisis, individuals and businesses increasingly turn to the bankruptcy system asking for relief to help them navigate times of financial distress.<sup>1</sup> Historically, bankruptcy filings closely tracked unemployment rates.<sup>2</sup> While that correlation has been reversed during the COVID-19 pandemic so far,<sup>3</sup> the American Bankruptcy Institute predicts that filings will sharply increase in the years to come.<sup>4</sup>

If and when that happens, many individuals will resort to bankruptcy in an effort to save their homes.<sup>5</sup> On its face, the Bankruptcy Code provides a potentially significant tool that may be utilized by debtors to achieve that goal—bifurcation of a claim secured by a mortgage on real property.<sup>6</sup>

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1. Jialan Wang, Jeyul Yang, Benjamin Iverson & Raymond Kluender, *Bankruptcy and the COVID-19 Crisis*, 1 (Harv. Bus. Sch., Working Paper 21-041, 2020), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3690398](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3690398) [<https://perma.cc/E2LV-JG2W>].

2. *Id.* at 2.

3. *Id.* at 14. According to weekly filing data compiled by the American Bankruptcy Institute from PACER, total bankruptcy filings since March 2020 were consistently lower throughout the year, by approximately 40% compared to the same weeks in 2019. Ed Flynn, *Weekly Bankruptcy Analysis: November 23–29, 2020*, AM. BANKR. INST. (Nov. 21, 2020, 5:42 PM), <https://www.abi.org/covid-19/weekly-reports> [<https://perma.cc/298N-Z8C3>]. While Chapter 11 filings were generally up throughout the period, the overwhelming majority of filings comprised of Chapter 7 and Chapter 13 cases which were experiencing sharp drops in filing rates. *Id.*; see also Wang, Yang, Iverson & Kluender, *supra* note 1, at 11–13 (attributing the decrease in filings to the initial bankruptcy court shutdowns and outbreaks, social distancing policies and changes in court procedures, liquidity constraints, uncertainty regarding the availability of federal aid, federal, state, and local moratoria imposed on evictions and foreclosures, massive federal aid packages, and other forms of relief implemented by localities and industry participants).

4. *Q & A: Will Bankruptcy Filings Reach Record Levels?*, AM. BANKR. INST. (Dec. 22, 2020, 2:27 PM), <https://s3.amazonaws.com/abi-org-corp/covid19/documents/Bankruptcy%20Filings.pdf> [<https://perma.cc/38N9-SP3H>] (expecting a sharp increase in filings in the next few years, and explaining that the current filing drop is attributable to the surge in unemployment which caused millions of Americans to lose regular income needed to fund a Chapter 13 plan).

5. Richard S. Gendler, *Home Mortgage Cramdown in Bankruptcy*, 22 AM. BANKR. INST. L. REV. 329, 330–31 (2014).

6. 11 U.S.C. §§ 506(a), 1123(b)(5), 1190(3), 1322(b)(2); see also Gendler, *supra* note 5, at 333 (referencing bifurcation or “cramdown” as the most significant type of claim modification).

If the value of the mortgaged property is less than the face amount of the claim the mortgage secures, the debtor may have the right, in a subsequent bankruptcy case, to bifurcate the claim into a secured portion equal to the value of the property, and an unsecured portion for the remainder.<sup>7</sup> In most cases, this effectively reduces—sometimes significantly—the total amount of payments the debtor must make on account of that claim under her reorganization plan.<sup>8</sup> As a result, the debtor increases her chances to keep the encumbered property and achieve a “fresh start.”<sup>9</sup>

Unfortunately, the debtor’s efforts to save her home by means of bifurcation reach a dead end when the claim is secured by a mortgage on real property that is the “debtor’s principal residence.”<sup>10</sup> When that is the case, any bifurcation of the claim is prohibited by the anti-modification provisions of Title 11 of the United States Code (the “Bankruptcy Code”).<sup>11</sup>

But what real properties constitute the “debtor’s principal residence” within the sense of the anti-modification provisions? Does the subject property have to be used exclusively as the debtor’s principal residence for the anti-modification provisions to apply? Or do the provisions apply also to mixed-use real property—that is, property used by the debtor as her principal residence, as well as for additional purposes? Courts have repeatedly struggled with this question.

Take, for example, a debtor who takes out a loan to acquire a two-family dwelling and secures the loan by a mortgage on the property. The debtor moves in and begins to principally reside in one of the units. Further, to help the debtor pay-off the loan, she decides to rent out the second unit to a tenant. As a result, the debtor now uses the property in part as her principal residence, and in part as rental property. Another debtor principally resides in a different single- or multi-unit property, and, without renting a portion of the property to a third party, simultaneously uses part of the property to run a home business.

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7. *Id.*

8. For more detailed discussion of this point, see *infra* notes 28–33 and accompanying text.

9. See Gendler, *supra* note 5, at 405 (highlighting “fresh start” as one of the main goals the United States bankruptcy system is designed to assist debtors to achieve).

10. 11 U.S.C. §§ 1123(b)(5), 1322(b)(2).

11. *Id.*

Do the above properties represent the debtor's principal residence? Does it matter whether the underlying mortgage agreement also created a security interest in rents, or, more broadly speaking, income generated from the property? In escrow funds and insurance proceeds pertaining to the property? And, if the use of the subject property by the debtor matters, should the court consider the manner in which the debtor used the property as of the loan-origination date, or the date of the filing of the bankruptcy petition?

If the predictions regarding the surge of personal bankruptcies in the following years come true, these questions will likely be once again occupying the court system and litigants. For this reason, this Note attempts to propose some sensible answers.

Part I of this Note provides an overview of the right of a debtor-in-bankruptcy to modify a mortgage on her home and discusses the evolution of the anti-modification provisions from the enactment of the Bankruptcy Code in 1978 to the present day. Part II surveys three interpretive approaches to the question of what constitutes a debtor's principal residence. Finally, Part III proposes the adoption of an approach which, in the author's opinion, is the most faithful to the language of the Bankruptcy Code as well as the purpose of the anti-modification provisions.

## I. LEGAL BACKGROUND

The Bankruptcy Code defines a "claim" as the right to (i) any payment, or (ii) an equitable remedy for breach of performance if such breach gives rise to payment.<sup>12</sup> A claim that is (i) allowed under § 502, and (ii) secured by a "lien" on property is a "secured claim" to the extent of the value of the property.<sup>13</sup> To the extent such allowed claim exceeds the value of the property, it is an "unsecured claim."<sup>14</sup> A "lien" is defined as "charge against or interest in property to secure payment of a debt or performance of an obligation."<sup>15</sup> Accordingly, a "holder of a secured claim" is a creditor entitled to performance owed by the debtor with respect to such secured claim.<sup>16</sup>

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12. 11 U.S.C. § 101(5).

13. 11 U.S.C. § 506(a)(1).

14. *Id.*

15. 11 U.S.C. § 101(37).

16. *See* 11 U.S.C. §§ 101(10), 506(a)(1).

## A. THE MODIFICATION RIGHT IN GENERAL

Subject to the limitation discussed below, a debtor's reorganization plan may propose to "modify" the rights of "holders of secured claims."<sup>17</sup> Modification represents "any fundamental alteration in a debtor's obligations."<sup>18</sup> It may take the form, for example, of a reduction of monthly payments,<sup>19</sup> extension of the repayment period,<sup>20</sup> amendment of the payment schedule,<sup>21</sup> alteration of the nature or rate of interest,<sup>22</sup> or, most significantly, bifurcation of a claim of an "undersecured creditor."<sup>23</sup> A creditor is undersecured when it holds an allowed claim secured by a lien on property, the value of which is less than the amount of such claim.<sup>24</sup>

Bifurcation represents the most significant form of modification.<sup>25</sup> Upon bifurcation, the original claim gets split into two portions—a secured portion equal in amount to the value of the collateral, and an unsecured portion for the remainder.<sup>26</sup> Bifurcation effectively reduces the amount the debtor has to repay to achieve a "fresh start."<sup>27</sup>

For example, in a typical consumer case<sup>28</sup> administered under Chapter 13 of the Bankruptcy Code, the holder of a bifurcated claim is entitled to receive a stream of payments with a value equal to the present

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17. 11 U.S.C. §§ 1123(b)(5), 1190(3), 1322(b)(2).

18. Cf. *In re Litton*, 330 F.3d 636, 643 (4th Cir. 2003).

19. *Grubbs v. Houston First Am. Sav. Ass'n*, 730 F.2d 236, 246 (5th Cir. 1984).

20. *In re Gwinn*, 34 B.R. 936, 944 (Bankr. S.D. Ohio 1983).

21. *In re Cooper*, 98 B.R. 294, 299 (Bankr. W.D. Mich. 1989).

22. *In re Coffey*, 52 B.R. 54, 55 (Bankr. D.N.H. 1985).

23. *In re Schum*, 112 B.R. 159, 160 (Bankr. N.D. Tex. 1990).

24. The Bankruptcy Code does not use the term "undersecured creditor." Instead, it uses the term "creditor" or "holder of a claim"—whether secured or unsecured. Yet, the term "undersecured creditor" has emerged to refer to a creditor whose claim, secured under the applicable non-bankruptcy law, gets split into a secured and unsecured portion in bankruptcy by virtue of the operation of § 506(a)(1) discussed below. See 11 U.S.C. § 506(a)(1).

25. Gendler, *supra* note 5, at 333.

26. 11 U.S.C. § 506(a).

27. See Gendler, *supra* note 5, at 405.

28. More precisely, eligibility for Chapter 13 is limited to "individuals with regular income" who satisfy certain debt limits. 11 U.S.C. § 109(e). An "individual" is an undefined term. It refers to a natural person and represents a sub-category of a broader, defined term "person." See 11 U.S.C. § 101(41). The Bankruptcy Code does not use the term "consumer." In some circumstances, however, it does use the term "consumer debt." 11 U.S.C. § 101(8).



value of the secured portion of the claim.<sup>29</sup> On account of the unsecured portion of the claim, however, that same creditor is entitled to receive a pro rata share of the greater of (i) the amount general unsecured creditors would receive in a Chapter 7 liquidation of the debtor;<sup>30</sup> or (ii) the debtor's projected disposable income in the applicable commitment period.<sup>31</sup> In effect, because unsecured creditors usually receive only cents on the dollar,<sup>32</sup> bifurcation frequently results in a significant reduction of the payments to be made by the debtor under a confirmed plan when compared to the payments the debtor would have to make had she not filed for bankruptcy.<sup>33</sup>

Modification must be distinguished from a "cure" of a claim.<sup>34</sup> A cure "reinstates a debt to its pre-default position, or it returns the debtor and creditor to their respective positions before the default."<sup>35</sup> Distinguishing between a cure and a modification bears a significant practical relevance. While a debtor has the right to cure just about any claim,<sup>36</sup> the debtor cannot modify a claim secured solely by a mortgage on her home.<sup>37</sup>

This limitation is imposed by the anti-modification provisions of the Bankruptcy Code.<sup>38</sup> The provisions deny a debtor the right to modify "a claim secured only by a security interest in real property that is the debtor's principal residence . . . ."<sup>39</sup>

The anti-modification provisions prohibit a debtor from bifurcating even a claim of an undersecured creditor that would otherwise get

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29. 11 U.S.C. § 1325(a)(5)(B)(ii).

30. 11 U.S.C. § 1325(a)(4).

31. 11 U.S.C. § 1325(b)(1)(B).

32. Adam J. Levitin & Joshua Goodman, *The Effect of Bankruptcy Strip-Down on Mortgage Markets 2* (Georgetown Univ. Law Ctr., Research Paper No. 1087816, 2008).

33. *See id.* (stressing that the significance of bifurcation follows from the fact that it "affects the treatment of the principal amount of the creditor's claim, not just the interest.").

34. Sections 1123(a)(5)(G) and 1322(b)(3) allow a debtor, in the plan of reorganization, to provide for the "curing or waiving of any default." 11 U.S.C. §§ 1123(a)(5)(G), 1322(b)(3).

35. *In re Litton*, 330 F.3d 636, 644 (4th Cir. 2003).

36. 11 U.S.C. §§ 1123(a)(5)(G), 1322(b)(3).

37. 11 U.S.C. §§ 1123(b)(5), 1322(b)(2).

38. 11 U.S.C. §§ 1123(b)(5), 1322(b)(2). The anti-modification provisions of Chapter 11 and Chapter 13 contain virtually identical wording. Accordingly, each reference, analysis, or conclusion pertaining to either of these provisions found in this Note is equally applicable to both.

39. 11 U.S.C. § 1123(b)(5).

bifurcated by virtue of the application of § 506(a).<sup>40</sup> In this respect, the anti-modification provisions operate as special provisions suspending the general treatment of claims of undersecured creditors under § 506(a).<sup>41</sup>

Since the enactment of the Bankruptcy Code in 1978, Congress has revisited the anti-modification provisions several times to add specificity to this language. The emerging circuit split that is the subject of this Note involves decisions rendered over time which considered distinct statutory language of the Bankruptcy Code. These statutory amendments may implicate courts' rationales in some of these decisions. To determine the continued applicability of these decisions under the current state of the Bankruptcy Code, I consider it critical to analyze each of the relevant decisions in its historical context as relates to the statutory language in existence at the time of the issuance of the opinion. Accordingly, in the following subsection, I provide an overview of the legislative history of the development of the anti-modification provisions.

B. THE ANTI-MODIFICATION PROVISIONS: FROM THE INCEPTION OF  
THE BANKRUPTCY CODE TO THE PRESENT DAY

In 1978, Congress enacted the "Act to Establish a Uniform Law on the Subject of Bankruptcies," which became known as the Bankruptcy Code.<sup>42</sup> Since its inception, the Bankruptcy Code contained the anti-modification provision set out in § 1322(b)(2).<sup>43</sup> The provision enables a debtor to "modify the rights of holders of secured claims, *other than a claim secured only by a security interest in real property that is the debtor's principal residence . . .*"<sup>44</sup> The language of the provision remained unchanged since the Bankruptcy Code's enactment.

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40. See 11 U.S.C. §§ 1123(b)(5), 506(a).

41. See *id.*; see also Gendler, *supra* note 5, at 378–79:

Section 506(a) deals merely with a claim's classification, not with its treatment once classified. Once a claim is classified its treatment is determined under the pertinent Code sections . . . It is the modification of the creditor's rights and not the classification of his or her claim that is protected under [the anti-modification provisions].

42. Pub. L. No. 95-598, 92 Stat. 2549.

43. 11 U.S.C. § 1322(b)(2); Pub. L. No. 95-598, 92 Stat. 2549.

44. 11 U.S.C. § 1322(b)(2) (emphasis added).

Over a decade later, Congress enacted the Bankruptcy Reform Act of 1994,<sup>45</sup> amending the Bankruptcy Code to provide for a virtually identical counterpart of the modification right to debtors whose cases are being administered under Chapter 11 of the Bankruptcy Code.<sup>46</sup>

Since the insertion of both anti-modification provisions in the Bankruptcy Code, the operational language of the provisions has remained unchanged. What did subsequently change, however, is the specificity with which the Bankruptcy Code defined the core term in the provisions: the “debtor’s principal residence.”<sup>47</sup> Since its enactment in 1978, the Bankruptcy Code had not defined the term. It remained undefined, despite amendments enacted in 1994 to extend the application of the anti-modification standard from Chapter 13 to Chapter 11 plan confirmation. Instead, courts construing the phrase during this period implicitly supplied their own definition of “debtor’s principal residence,” relying either on close textual analysis or proclamation of legislative intent.<sup>48</sup>

Congress stepped in to add an express definition of the term in the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (“BAPCPA”).<sup>49</sup> BAPCPA defined a debtor’s principal residence as:

(A) mean[ing] a residential structure, including incidental property, without regard to whether that structure is attached to real property; and (B) includ[ing] an individual condominium or cooperative unit, a mobile or manufactured home, or trailer . . . .<sup>50</sup>

BAPCPA further explicated the definition of debtor’s principal residence by separately defining “incidental property” as:

[M]ean[ing], with respect to a debtor’s principal residence[,] (A) property commonly conveyed with a principal residence in the area where the real property is located; (B) all easements, rights, appurtenances, fixtures, rents, royalties, mineral rights, oil or gas

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45. Pub. L. No. 103-394, 108 Stat. 4106 (1994).

46. 11 U.S.C. § 1123(b)(5); Pub. L. No. 103-394, § 206, 108 Stat. 4106; *see also In re Scarborough*, 461 F.3d 406, 413 (3d Cir. 2006) (“With the addition of this provision, Congress sought to ‘conform[] the treatment of residential mortgages in [C]hapter 11 to that in [C]hapter 13.’” (quoting H.R. REP. NO. 835, at 46 (1994))).

47. 11 U.S.C. §§ 1123(b)(5), 1322(b)(2).

48. *See, e.g., Scarborough*, 461 F.3d at 411 (relying on textual analysis); *Lomas Mortg., Inc. v. Louis*, 82 F.3d 1, 4 (1st Cir. 1996) (resorting to legislative history).

49. Pub. L. No. 109-8, 119 Stat. 23 (2005).

50. Pub. L. No. 109-8, § 306(c)(1), 119 Stat. 23 (codified at 11 U.S.C. § 101(13A)).

rights or profits, water rights, escrow funds, or insurance proceeds;  
and (C) all replacements or additions . . . .<sup>51</sup>

Both definitions introduced by BAPCPA are applicable to cases filed after October 17, 2005.<sup>52</sup> While the definition of incidental property has remained unchanged since its enactment, Congress revised the definition of a debtor's principal residence with the Bankruptcy Technical Corrections Act of 2010 ("BTCA").<sup>53</sup>

The BTCA inserted a qualifier in both subsections of the definition of a debtor's principal residence. This qualifying language specifies that the residential structure in question must actually be "*used* as the principal residence by the debtor" to meet the definition's criteria.<sup>54</sup> The BTCA became effective on December 22, 2010, and, unlike the BAPCPA, does not contain provisions addressing the temporal scope of its applicability.<sup>55</sup> Since the BTCA, the definition of debtor's principal residence has not been further amended.

Upon inserting the current wording of the definition of the debtor's principal residence into the language of the anti-modification provisions, the provisions should be read as follows:

[The debtor cannot modify] a claim secured only by a security interest in real property that:

(A) [is] a residential structure if used as the principal residence by the debtor, including incidental property, without regard to whether that structure is attached to real property; and

(B) includes an individual condominium or cooperative unit, a mobile or manufactured home, or trailer if used as the principal residence by the debtor.<sup>56</sup>

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51. Pub. L. No. 109-8, § 306(c)(2), 119 Stat. 23 (codified at 11 U.S.C. § 101(27A)).

52. Pub. L. No. 109-8, § 1501(a), (b), 119 Stat. 23.

53. Pub. L. No. 111-327, § 2(a)(1)(A), 124 Stat. 3557 (2010).

54. Pub. L. No. 111-327, § 2(a)(1)(A), 124 Stat. 3557 (codified at 11 U.S.C. § 101(13A)) (emphasis added).

55. Pub. L. No. 111-327, 124 Stat. 3557.

56. Combining the language of 11 U.S.C. §§ 1123(b)(5), 1322(b)(2), and 101(13A).

The following section analyzes the relevant case law and draws conclusions in view of the historical context outlined above.

## II. DEVELOPING CIRCUIT SPLIT OVER THE MEANING OF THE DEBTOR'S PRINCIPAL RESIDENCE

Courts have developed three distinct interpretive approaches to the treatment of claims secured only by a security interest in mixed-use real property owned by an individual. First, some courts hold that the anti-modification provisions apply only to real property that is used by an individual debtor exclusively as a principal residence (the “Residential-Use-Only Approach”).<sup>57</sup> Second, other courts apply the anti-modification provisions to real property that has been intended by the parties to be used primarily as residential property (the “Case-by-Case Approach”).<sup>58</sup> Finally, contrary to the Residential-Use-Only Approach, some courts hold that the anti-modification provisions apply to real property that is used by the debtor as her principal residence, even if the property is also used for additional, non-residential purposes (the “Mixed-Use Approach”).<sup>59</sup> Each of the approaches is addressed in more detail below.

### A. THE RESIDENTIAL-USE-ONLY APPROACH: THE ANTI-MODIFICATION PROVISIONS APPLY ONLY TO REAL PROPERTY USED EXCLUSIVELY BY THE DEBTOR AS A PRINCIPAL RESIDENCE

Courts that adopted the Residential-Use-Only Approach refuse to extend the anti-modification protection to any claim that is secured by a security interest in real property that is not used by the debtor exclusively as her principal residence. This approach appears to represent the majority rule.<sup>60</sup> Although courts in this category reach the same conclusion, they arrive at this holding by following distinct rationales.

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57. See *infra* Section II.A.

58. See *infra* Section II.B.

59. See *infra* Section II.C.

60. *In re* Krus, 582 B.R. 218, 221 (Bankr. W.D. Wis. 2018) (referring to the first approach as the “majority rule”); *In re* Moorer, 544 B.R. 702, 705 (Bankr. M.D. Ala. 2016) (same).

1. *Congressional Intent: The Anti-Modification Provisions Are Ambiguous*

Some courts find the text of the anti-modification provisions ambiguous and, by resorting to legislative history, resolve this ambiguity to require exclusively residential use.<sup>61</sup> These courts find ambiguity both before and after the enactment of the BAPCPA and the BTCA.

Pre-BAPCPA and BTCA, the mortgagee in *Lomas Mortgage, Inc. v. Louis* held a security interest in a three-family home, with the debtors principally residing in one unit, the second unit occupied by a relative of the debtors, and the third unit rented to a third party.<sup>62</sup>

The First Circuit acknowledged two plausible constructions of the anti-modification provisions.<sup>63</sup> Under one interpretation, the term “only” in the text of the provisions requires that the collateral in issue is comprised solely of real property, as opposed to personal property or the combination of real and personal property.<sup>64</sup> Alternatively, a narrower interpretation would read the term “only” in conjunction with the verb “is” to require “complete and exclusive identity between ‘real property’ and ‘principal residence.’”<sup>65</sup>

Because the court found the text of the provisions inconclusive, it resorted to legislative history.<sup>66</sup> The court found that while legislative history “does tend to show that with § 1322(b)(2) Congress wanted to benefit the residential mortgage market as opposed to the entire real estate mortgage market . . . the legislative history does not state with clarity how a mortgage on a mixed property . . . should be treated.”<sup>67</sup>

Seeking additional guidance, the court examined legislative history of § 1123(b)(5)—Chapter 11’s virtually identical counterpart to the anti-modification provision of Chapter 13.<sup>68</sup> The *Lomas* court found in the legislative history references to cases where the anti-modification

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61. *E.g.*, *Lomas Mortg., Inc. v. Louis*, 82 F.3d 1, 4 (1st Cir. 1996); *In re Abrego*, 506 B.R. 509, 515 (Bankr. N.D. Ill. 2014).

62. *Lomas*, 82 F.3d at 2.

63. *See id.* at 4.

64. *See id.*

65. *Id.*

66. *Id.*

67. *Id.* at 5.

68. *Id.* at 6.

provision should not apply, including *In re Ramirez*.<sup>69</sup> In *Ramirez*, the court permitted modification of a claim secured by a mortgage on real property consisting of the debtor's principal residence and two rental units.<sup>70</sup>

Additionally, as a matter of policy, the *Lomas* court was concerned that extending the anti-modification protection to multi-unit dwellings would create a "difficult line-drawing problem."<sup>71</sup> The court noted that "[i]t is unlikely Congress intended the anti-modification provision to reach a 100-unit apartment complex simply because the debtor lives in one of the units."<sup>72</sup> Thus, it concluded, "[l]imiting the anti-modification provision to single-family dwellings creates a more easily administered test."<sup>73</sup>

Based on the foregoing, the *Lomas* court found a "clear expression of congressional intent" that the anti-modification provisions do not apply to multi-unit properties, and permitted the modification sought by the debtors.<sup>74</sup>

Post-BAPCPA and BTCA, the court in *Abrego* also concluded that the anti-modification provisions are ambiguous.<sup>75</sup> The *Abrego* court sided with the First Circuit's reasoning that, "while the legislative history of § 1322(b)(2) is not helpful, this court agrees with *Lomas* that the legislative history to § 1123(b)(5) is instructive," and found analogous facts to those of *Ramirez*.<sup>76</sup> Thus, the court in *Abrego* similarly held that the anti-modification provisions do not apply to multi-unit dwellings.<sup>77</sup> It also held that the loan origination date is the relevant moment at which the nature of the real property in question shall be determined.<sup>78</sup> Given that as of the origination of the affected mortgage the debtors had rented part of the subject property, the court allowed modification.<sup>79</sup>

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69. *Id.* (citing *In re Ramirez*, 62 B.R. 668 (Bankr. S.D. Cal. 1986)).

70. *Ramirez*, 62 B.R. at 668.

71. *Lomas*, 82 F.3d at 6.

72. *Id.*

73. *Id.*

74. *Id.* at 7.

75. *In re Abrego*, 506 B.R. 509, 514 (Bankr. N.D. Ill. 2014).

76. *Id.*

77. *See generally id.* Interestingly, the *Abrego* court reached its conclusion without ever considering, at least in the text of the opinion, the changes introduced by the BAPCPA and the BTCA.

78. *Id.* at 516.

79. *Id.*

2. *Textual Analysis: The Anti-Modification Provisions Are Unambiguous*

Some courts have adopted the Residential-Use-Only Approach by relying primarily on textual analysis of the anti-modification provisions, finding them unambiguous. These courts find sufficient clarity in the text of the provisions both before and after the enactment of the BAPCPA and the BTCA.

*In re Scarborough* is an example of a pre-BAPCPA<sup>80</sup> and BTCA decision following textual analysis. In *Scarborough*, the Third Circuit addressed whether the anti-modification provisions extend to multi-unit dwellings.<sup>81</sup> In that case, the mortgaged property was a two-story residence—the debtor lived downstairs and rented the second-floor apartment to a tenant.<sup>82</sup>

First, the *Scarborough* court analyzed whether the subject property must be used by the debtor exclusively as a principal residence for the anti-modification protection to attach.<sup>83</sup> The court focused on the presence of the verb “is” in the portion of the anti-modification provisions which reads: “real property that *is* the debtor’s principal residence . . . .”<sup>84</sup> The court reasoned that by including the verb “is” in the quoted text, “Congress equated the terms ‘real property’ and ‘principal residence.’”<sup>85</sup> Following this “equating logic,” the court determined that “the real property that secures the mortgage must be only the debtor’s principal residence in order for the anti-modification provision to apply.”<sup>86</sup> Put differently, the court continued, “[a] claim secured by real property that is, even in part, not the debtor’s principal residence” can be modified.<sup>87</sup>

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80. More precisely, *Scarborough* was decided in 2006—following BAPCPA’s effective date. *In re Scarborough*, 461 F.3d 406, 412 n.2 (3d Cir. 2006). However, because the main case in *Scarborough* was commenced four years before the effective date, BAPCPA did not apply. *Id.* Thus, the Third Circuit expressly left the consideration of BAPCPA’s impact on the issue before the court for another day. *Id.*

81. *Id.* at 410–11.

82. *Id.* at 409.

83. *Id.* at 411.

84. *Id.*; 11 U.S.C. § 1322(b)(2) (emphasis added).

85. *Scarborough*, 461 F.3d at 411.

86. *Id.*

87. *Id.*



Next, the *Scarborough* court recognized that such reading of the anti-modification provisions subjects the principal-residence status of real property to the will of the debtor.<sup>88</sup> To address this issue, the court held that the nature of the subject property is determined as of the moment the mortgage is created.<sup>89</sup> If the debtor uses her home solely as a principal residence at the time the mortgage was entered into, the anti-modification protection will attach, and no future change in the use of the property will remove it.<sup>90</sup> Because the lender in *Scarborough* took a mortgage on real property that was, at the time of loan origination, partly residential, partly income-producing rental property, the court allowed modification of the claim secured by the mortgage as consistent with the mortgagee's expectations.<sup>91</sup>

Following enactment of the BAPCPA and the BTCA, some courts continue to apply the textual approach adopted in *Scarborough* despite the language of the definitions introduced with these amendments. These courts can be further divided into two sub-groups. Some of the courts continue to follow this approach without even acknowledging the changes introduced by these statutory enactments.<sup>92</sup> Other courts take the new definitions into account but diminish their relevance.<sup>93</sup>

In *In re Picchi*, the Bankruptcy Appellate Panel for the First Circuit adopted the same approach, and allowed the modification of a mortgage on a two-family dwelling.<sup>94</sup> In doing so, the Appellate Panel primarily

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88. *Id.* at 412 (“[A] debtor could easily sidestep the . . . home mortgage exception by adding a second living unit to the property on the eve of the commencement of his Chapter 13 proceeding.” (quoting *In re Bulson*, 327 B.R. 830, 846 (Bankr. W.D. Mich. 2005))).

89. *Id.* (“It is at that point in time that the underwriting decision is made and it is therefore at that point in time that the lender must know whether the loan it is making may be subject to modification in a Chapter 13 proceeding at some later date.” (quoting *Bulson*, 327 B.R. at 846)).

90. *Id.*

91. *Id.* at 414.

92. See, e.g., *In re Krus*, 582 B.R. 218, 222 (Bankr. W.D. Wis. 2018) (adopting the first approach without discussing the BAPCPA, the BTCA, or the relevant definitions introduced by these amendments); *In re Moorier*, 544 B.R. 702, 706 (Bankr. M.D. Ala. 2016) (same).

93. See, e.g., *In re Picchi*, 448 B.R. 870, 875 (B.A.P. 1st Cir. 2011); *In re Jordan*, 403 B.R. 339, 346 (Bankr. W.D. Pa. 2009); *In re Davis*, 386 B.R. 182, 187 (B.A.P. 6th Cir. 2008).

94. *Picchi*, 448 B.R. at 871. Technically, because the Bankruptcy Appellate Panel for the First Circuit issued its decision in *Picchi* in reliance on the First Circuit's precedent in *Lomas* discussed above, *Picchi* is an example of a case relying on

relied on the First Circuit's precedential holding in *Lomas*, which had found that the anti-modification provisions were ambiguous.<sup>95</sup> In addition, the court addressed whether the *Lomas* court's holding has been abrogated by the clarifying definitions of "debtor's personal residence"<sup>96</sup> and "incidental property"<sup>97</sup> introduced by the BAPCPA.<sup>98</sup> The court made two textual points regarding the impact of the BAPCPA.

First, while interpreting the definition of "debtor's principal residence," the *Picchi* court stated that the reference to "a residential structure" in sub-paragraph (A) of the definition is qualified by the list of "living units" in sub-paragraph (B).<sup>99</sup> The combination of the two sub-paragraphs left the court convinced that "a residential structure" can only refer to the debtor's "actual living unit."<sup>100</sup> Accordingly, because a rented unit does not represent a space encompassing an actual living unit of the debtor, but rather that of a tenant, it cannot be included in a "residential structure."<sup>101</sup>

Second, while focusing on the definition of "incidental property," the *Picchi* court rejected the creditor's assertion that the phrase

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legislative history rather than statutory text. However, because *Picchi* conducted a detailed textual analysis of the BAPCPA and its effects on the First Circuit's holding in *Lomas*, I discuss the case alongside other textual opinions.

95. *Id.* at 874. The court perceived the ambiguity slightly differently than the First Circuit did in *Lomas*. According to the *Picchi* court, the anti-modification provisions could be understood to bar modification of a claim secured by a security interest in real property that: (1) *includes* the debtor's principal residence; or (2) is *exclusively* the debtor's principal residence. *Id.*

96. 11 U.S.C. § 101(13A).

97. 11 U.S.C. § 101(27B).

98. *Picchi*, 448 B.R. at 874. The court did not address the effect of the BTCA of the First Circuit's holding in *Lomas*. As discussed above, the BTCA changed the definition of "debtor's principal residence" to require that the residential structure in which the principal residence is situated must actually be "used as the principal residence by the debtor . . ." Pub. L. No. 111-327, § 2(a)(1)(A), 124 Stat. 3557 (2010) (codified at 11 U.S.C. § 101(13A)). Nevertheless, the BTCA was enacted only after the briefs in *Picchi* were filed, the amendment does not specify its temporal scope, and neither party asked the court to determine whether the BTCA should apply. *Picchi*, 448 B.R. at 872. Accordingly, the court decided the case based on the law effective before the BTCA's enactment. *Id.*

99. *Id.* at 874. Sub-paragraph (B) of the definition of "debtor's principal residence" includes such "living units" as "an individual condominium or cooperative unit, a mobile or manufactured home, or trailer . . ." 11 U.S.C. § 101(13A)(B).

100. *Id.* at 875.

101. *See id.*

“including property commonly conveyed with a principal residence in the area where the real property is located[]” in sub-paragraph (A) of the definition can include a rental unit within a multi-unit dwelling.<sup>102</sup> Instead, the court sided with the bankruptcy court’s construction that the phrase includes objects like a “boiler, the attached garage, [or] the window treatments that are typically listed in a standard mortgage.”<sup>103</sup>

Based on the above, the court in *Picchi* held that “[t]he meaning and scope of [the anti-modification provisions] have not been altered by the definitions of ‘debtor’s principal residence’ and ‘incidental property’ introduced by BAPCPA.”<sup>104</sup>

The Fourth Circuit also addressed the impacts of the definitions introduced by BAPCPA in *In re Ennis*—a case involving a security interest in a mobile home.<sup>105</sup> The mobile home was the debtors’ principal residence, which sat on a lot leased by the debtors in a mobile home park.<sup>106</sup>

The court in *Ennis* stated that for the anti-modification provisions to apply, two requirements must be met: “first, the security interest must be in real property, and second, the real property must be the debtor’s principal residence.”<sup>107</sup> Further, the court continued, the definition of “debtor’s principal residence” pertains only to the second requirement and leaves in place the “real property” requirement.<sup>108</sup>

The court recognized that a debtor can situate her principal residence in personal property, such as a mobile home.<sup>109</sup> However, for the anti-modification protection to apply, the debtor’s principal residence must constitute real property—a requirement not abolished by the BAPCPA.<sup>110</sup> Thus, to prevent modification of a claim secured by a security interest in a mobile home, the mobile home must represent real property under the applicable non-bankruptcy law.<sup>111</sup>

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102. *Id.*

103. *Id.*

104. *Id.*

105. *In re Ennis*, 558 F.3d 343, 345 (4th Cir. 2009).

106. *Id.*

107. *Id.* at 345–46.

108. *Id.* at 346.

109. *Id.* (citing *Herrin v. GreenTree—Al, LLC*, 376 B.R. 316, 320 (S.D. Ala. 2007)).

110. *Id.*

111. *Id.* In the context of security interests in mobile homes, this is a widely accepted holding. *See, e.g., In re Jordan*, 403 B.R. 339, 346 (Bankr. W.D. Pa. 2009); *In re Davis*, 386 B.R. 182, 187 (B.A.P. 6th Cir. 2008).

The *Ennis* court found that the first requirement was undisputedly satisfied in this case—the mobile home was the debtor’s principal residence.<sup>112</sup> Thus, the remaining issue for the court to determine was whether the debtor’s mobile home represented real property under Virginia law, the applicable state law.<sup>113</sup> It found that Virginia law classified mobile homes as personal property.<sup>114</sup> Because the real property requirement was not met, the court allowed the modification sought by the debtors.<sup>115</sup>

The court in *In re Bradsher* applied the Fourth Circuit’s logic in a case where the creditor held a security interest both in real property that was the debtors’ principal residence and in escrow funds.<sup>116</sup> The *Bradsher* court recognized that post-BAPCPA, the definition of debtor’s principal residence explicitly includes, through the sub-definition of incidental property, escrow funds.<sup>117</sup> Following the Fourth Circuit’s reasoning in *Ennis*, however, the court stated that inclusion need not indicate that the anti-modification protection governs.<sup>118</sup> The protection applies only if escrow funds constitute real property under state law—in this case, North Carolina law.<sup>119</sup> Because the court found that under North Carolina law, escrow funds constitute personal property, the creditor’s claim was not secured only by a security interest in real property.<sup>120</sup> Accordingly, the court held that the claim is not entitled to the anti-modification protection.<sup>121</sup>

Although *Ennis*, *Bradsher*, and the courts that follow them do not specifically address multi-unit properties, the courts’ rationales for these holdings nonetheless suggest that a security interest simultaneously covering multi-unit property and rental income sits outside the reach of the anti-modification provisions. Unless rental income constitutes real property under the applicable state law or any claim to such rent is waived by the mortgagee, the anti-modification protection should not be viewed as governing—despite the language of the BAPCPA including

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112. *Id.*

113. *Id.*

114. *Id.* at 347.

115. *Id.*

116. *In re Bradsher*, 427 B.R. 386, 388 (Bankr. M.D.N.C. 2010).

117. *Id.* at 389.

118. *Id.* at 389–90.

119. *Id.* at 390.

120. *Id.* at 391.

121. *Id.* at 391–92.

rents in the definition of the debtor's principal residence through its sub-definition of incidental property.<sup>122</sup>

While the Residential-Use-Only Approach represents a bright-line rule, it has been criticized for potentially being subject to abuse by debtors. In *In re Zaldivar*, the court was concerned that this approach “would permit security interests to be modified on a debtor's primary residence when the debtor decides to rent out a garage apartment or convert a basement into a rentable apartment.”<sup>123</sup> Presumably, however, these concerns arise only when the court determines the principal-residence status of the subject property as of the petition date, as opposed to the loan origination date.

B. THE CASE-BY-CASE APPROACH: THE ANTI-MODIFICATION  
PROVISIONS APPLY TO REAL PROPERTY THAT HAS BEEN INTENDED BY  
THE PARTIES TO BE USED PRIMARILY AS THE DEBTOR'S RESIDENTIAL  
PROPERTY

Alternatively, some courts consider the totality of circumstances to determine the intention of the parties to a particular transaction. Specifically, these courts focus on whether the parties to a particular mortgage transaction predominantly intended to provide the debtor with: (i) a home; or (ii) the source of an investment income or the premises for the operation of a business.<sup>124</sup>

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122. See 11 U.S.C. § 101(13A)(A), (27B)(B); see also *In re Ferandos*, 402 F.3d 147 (3d Cir. 2005) (holding, pre-BAPCPA, that under New Jersey law, real property is defined to include rents, and, therefore, the grant of a security interest in rents in addition to the debtors' home did not render the claim secured by anything other than real property).

123. *In re Zaldivar*, 441 B.R. 389, 390 (Bankr. S.D. Fla. 2011); see also *In re Guilbert*, 176 B.R. 302, 305 (D.R.I. 1995) (stating that, under this approach, “homeowners poised to file for protection under Chapter 13 would, as a matter of course, seek temporary tenants prior to their filing, in order to modify the rights that their secured creditors have in their home.”).

124. E.g., *In re Brunson*, 201 B.R. 351, 353 (Bankr. W.D.N.Y. 1996); *Litton Loan Servicing, LP v. Beamon*, 298 B.R. 508, 512 (N.D.N.Y. 2003) (adopting this approach, and criticizing the Residential-Use-Only Approach adopted by the First and Third Circuits because it “arbitrarily exclude[s] multi-family residences that are both used as a principal residence and covered by a residential mortgage from the reach of [the anti-modification provisions] . . . [and] allow[s] modification of mortgages that are indisputably residential in nature.”); *In re Zaldivar*, 441 B.R. 389, 391 (Bankr. S.D. Fla. 2011) (holding that “the predominant character of the transaction governs whether the anti-modification provision applies.”).

To determine the parties' predominant intention, courts consider a number of factors, including whether the debtor owns other properties where she could reside, whether the debtor has a principal occupation other than as a landlord, the ratio of the income generated from the real estate to the debtor's total income, whether the mortgage was processed through the commercial or residential mortgage department of the creditor, the interest rate, the demographics of the relevant market, and the extent to which potential non-residential uses of the real property were considered by the creditor.<sup>125</sup>

After considering the above factors, courts determine whether the real property in question is primarily "commercial property," and therefore permits modification, or primarily "residential property," which is covered by the anti-modification protection.<sup>126</sup>

In *In re Baker*, the debtors sought modification of a loan secured by a mortgage on their principal residence, arguing that at its inception, the mortgage covered both the debtors' current residence as well as their old property.<sup>127</sup> Nevertheless, the court denied the request, finding a predominantly residential character to the transaction.<sup>128</sup> The court found that parties understood that the purpose of the transaction was to provide a bridge loan to the debtors which would enable them to acquire a new home, while simultaneously proceeding with the sale of the old one.<sup>129</sup>

The court in *In re Zaldivar* reached the opposite conclusion.<sup>130</sup> In *Zaldivar*, the mortgage agreement covered a duplex partly used by the debtor as her principal residence, partly rented to a third party.<sup>131</sup> The court focused on the fact that a family rider attached to the mortgage agreement deleted an otherwise standard provision establishing an owner-occupancy requirement.<sup>132</sup> The court stated that because the debtor was not required to occupy the subject property at all, the

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125. *In re Brunson*, 201 B.R. 351, 353 (Bankr. W.D.N.Y. 1996).

126. *See id.* at 354. In *Brunson*, the debtor sought modification of a mortgage on her two-family dwelling. *Id.* at 351. The opinion does not, however, apply the multi-factor test to the facts of the case. Instead, the *Brunson* court concluded by setting an evidentiary hearing consistent with the decision. *Id.* at 354.

127. *In re Baker*, 398 B.R. 198, 201 (Bankr. N.D. Ohio 2008).

128. *See id.* at 204.

129. *Id.*

130. *In re Zaldivar*, 441 B.R. 389, 391 (Bankr. S.D. Fla. 2011).

131. *Id.* at 389.

132. *Id.* at 391.

character of the transaction could not be viewed as predominantly residential.<sup>133</sup>

While some courts stated that this approach is the most faithful to congressional intent,<sup>134</sup> the Third Circuit in *Scarborough* was not convinced. The Third Circuit criticized this approach for “introduc[ing] uncertainty and unpredictability to residential mortgage transactions” and for “requir[ing] courts to engage in a subjective, hindsight analysis of the parties’ intentions.”<sup>135</sup>

C. THE MIXED-USE APPROACH: THE ANTI-MODIFICATION PROVISIONS APPLY TO REAL PROPERTY THAT IS USED BY THE DEBTOR AS PRINCIPAL RESIDENCE, EVEN IF THE PROPERTY IS ALSO USED FOR ADDITIONAL PURPOSES

Finally, some courts extend the anti-modification protection to claims secured by a mortgage on real property so long as the debtor uses the property as her principal residence, regardless of additional, non-residential uses of the property. While it seems that this approach remains the minority rule, it might also represent an emerging trend.<sup>136</sup>

Before enactment of the BAPCPA and the BTCA, courts adopting this approach deployed mostly textual arguments, focusing on the placement of the term “only” within the anti-modification provision.<sup>137</sup> To reiterate its wording, the provision prohibits the modification of “a claim secured *only* by a security interest in real property that is the debtor’s principal residence . . . .”<sup>138</sup>

In *Macaluso*, the debtor sought modification of a mortgage on a single parcel of property that included a tailor shop and two residential apartments, one of which was occupied by the debtor.<sup>139</sup> The court reviewed the first two interpretive approaches, and rejected both of

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133. *Id.* (citing *In re Brunson*, 201 B.R. 351, 354 (Bankr. W.D.N.Y. 1996)).

134. *E.g., id.* at 390–91 (“[T]he entire point of the anti-modification provision[s] . . . is to ‘encourage the flow of capital into the home lending market’ by reducing risk to mortgagees . . . .” (citing *Nobelman v. Am. Sav. Bank*, 508 U.S. 324, 332 (1993) (Stevens, J., concurring))); *In re Brunson*, 201 B.R. at 354 (stating that this approach “serves congressional intent of encouraging home mortgage lending . . .”).

135. *In re Scarborough*, 461 F.3d 406, 414 (3d Cir. 2006).

136. *In re Brooks*, 550 B.R. 19, 25 (Bankr. W.D.N.Y. 2016) (referring to the third approach as an emerging minority view).

137. *See, e.g., In re Macaluso*, 254 B.R. 799, 799 (Bankr. W.D.N.Y. 2000).

138. 11 U.S.C. § 1123(b)(5) (emphasis added).

139. *Macaluso*, 254 B.R. at 799.

them.<sup>140</sup> Instead, the court found that the language of the anti-modification provisions clearly and unambiguously requires the adoption of the Mixed-Use Approach.<sup>141</sup> In the court's view, the term "only" in the language of the provisions must be read as an adverb solely modifying the adjective "secured."<sup>142</sup> In other words, the *Macaluso* court reasoned, the word "only" does not limit application of the anti-modification provisions "to property that is used only as a principal residence, but [requires that] the only collateral is a single parcel of real estate . . . ."<sup>143</sup> Accordingly, the court denied the proposed modification.<sup>144</sup>

Post-BAPCPA and BTCA, a number of courts have adopted this approach, focusing primarily on textual analysis. In *In re Schayes*, the debtors purchased a house and lived in it with the intent to rent it out to generate income.<sup>145</sup> The debtors' property was a single-family residence.<sup>146</sup> Nevertheless, they proposed a modification of their mortgage relying on *Scarborough*'s holding rendered in a multi-unit context, requiring that the subject property is used solely for residential purposes.<sup>147</sup> The debtors alleged that because they held the property with the intent to generate income, the property was used for both commercial and residential purposes.<sup>148</sup>

The *Schayes* court stated that *Scarborough* and its progeny were significantly factually distinguishable simply because they dealt with multi-unit dwellings.<sup>149</sup> The court went further, however, and stated that "even if *Scarborough* were not factually distinguishable . . . it is not supported by the plain language of the statute."<sup>150</sup> The court held that, rather than to follow the pre-BAPCPA statutory interpretation, "the better statutory analysis seems to be that other, additional actual uses have no relevance under the plain language of the Bankruptcy Code, so

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140. *Id.* at 800.

141. *Id.*

142. *Id.*

143. *Id.*

144. *Id.*

145. *In re Schayes*, 483 B.R. 209, 210–11 (Bankr. D. Ariz. 2012).

146. *Id.* at 211.

147. *Id.* at 215.

148. *Id.*

149. *Id.* at 216.

150. *Id.*



long as there is an actual use as the debtor's principal residence."<sup>151</sup> Because the court found that the debtors were actually using the house as their principal residence, their request for modification was denied.<sup>152</sup>

In *In re Wages*, the Bankruptcy Appellate Panel for the Ninth Circuit analyzed proposed modification of a mortgage on property that the debtors used as their principal residence, to park tractors and trailers used in the debtors' trucking business, and as an office from which they operated the trucking business.<sup>153</sup> The Appellate Panel first held that the petition date, not the loan origination date, should determine the use and nature of the subject property.<sup>154</sup> Next, the court stated that for the anti-modification provisions to apply, three requirements must be met: "first, the security interest must be in real property; second, the real property must be the only security for the debt; and third, the real property must be the debtor's principal residence."<sup>155</sup> Because there was no dispute that the first two requirements were met, the court focused on the third.<sup>156</sup>

On the question of whether the collateral was the debtor's principal residence, the *Wages* court first reviewed the Residential-Use-Only Approach.<sup>157</sup> It disagreed with the *Scarborough* court's "parsing of the words" of the anti-modification provisions because this approach disregards the definition of "debtor's principal residence."<sup>158</sup> The *Wages* court stated that "the definition avoids defining 'real property' and also clarifies that whether a structure is a principal residence is independent of whether it might be real property."<sup>159</sup> Thus, it reasoned, *Scarborough*'s equating of "real property" with "debtor's principal residence" is misplaced.<sup>160</sup>

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151. *Id.*

152. *Id.* at 217.

153. *In re Wages*, 508 B.R. 161, 163 (B.A.P. 9th Cir. 2014).

154. *Id.* at 164. The court did not elaborate on this portion of its holding, and referred to its settled case law on the issue instead. *Id.* (citing *In re Abdelgadir*, 455 B.R. 896, 902–03 (B.A.P. 9th Cir. 2011); *In re Benafel*, 461 B.R. 581, 591 (B.A.P. 9th Cir. 2011); *In re Wind N' Wave*, 328 B.R. 176, 181 (B.A.P. 9th Cir. 2005)).

155. *In re Wages*, 508 B.R. at 165.

156. *Id.*

157. *Id.*

158. *Id.* at 166. To give credit to the Third Circuit's "parsing of the words" in *Scarborough*, note that the definition of "debtor's principal residence" was not applicable in that case due to the BAPCPA's temporal scope. *In re Scarborough*, 461 F.3d 406, 412 n.2 (3d Cir. 2006).

159. *Wages*, 508 B.R. at 166.

160. *Id.*

The court then turned to the Case-by-Case Approach. It rejected the approach for being inconsistent with the court's case law regarding the relevant moment at which the court determines the nature and use of the subject property.<sup>161</sup> As noted above, the court makes this determination as of the petition date.<sup>162</sup> The Case-by-Case Approach, on the other hand, looks to the parties' intention as of the loan origination date.<sup>163</sup>

Thus, the court turned to the Mixed-Use Approach. The court rejected the notion that the anti-modification protection does not attach unless: (i) the subject property is being used exclusively as the debtor's principal residence; or (ii) the commercial use of the property becomes sufficiently significant.<sup>164</sup> As the court simply put it, "either a property is a debtor's principal residence or it is not."<sup>165</sup> Further, the court rejected the debtors' argument that the word "only" in the language of the provisions requires that the subject property serves only one function, that of being a principal residence.<sup>166</sup> Instead, the court agreed with the *Schayes* court, which reasoned that the word "only" simply requires that the sole collateral securing the subject mortgage is real property.<sup>167</sup>

Based on the above, the *Wages* court held that "the anti-modification [provision] applies to any loan secured only by real property that the debtor uses as a principal residence property, even if that real property also serves additional purposes."<sup>168</sup> It thus denied the debtors' proposal to modify their mortgage.<sup>169</sup>

In *In re Addams*, the debtor sought modification of a mortgage on her multi-unit property.<sup>170</sup> The debtor principally resided in one of the units, while renting out the second unit to a third party.<sup>171</sup> In addition, the repayment of the relevant note was secured not only by a mortgage on the real property itself, but also by an assignment of rents generated

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161. *Id.*

162. *Id.* (citations omitted).

163. *Id.*

164. *Id.* at 167.

165. *Id.*

166. *Id.*

167. *In re Schayes*, 483 B.R. 209, 215 (Bankr. D. Ariz. 2012). And, as noted above, in *Wages* there was no dispute that this requirement had been satisfied. *Wages*, 508 B.R. at 165.

168. *Wages*, 508 B.R. at 168.

169. *Id.*

170. *In re Addams*, 564 B.R. 458, 459 (Bankr. E.D.N.Y. 2017).

171. *Id.*

by renting the second unit.<sup>172</sup> The *Addams* court stressed that Congress defined “debtor’s principal residence” to include, through the accompanying definition of “incidental property,” rents derived from real property.<sup>173</sup> It follows that “a security interest in rents is part of the security interest in the principal residence.”<sup>174</sup> Therefore, the court stated, simply because the debtor “had a right to rent out a portion of the [property] and the [creditors] had a security in such rentals does not change the conclusion that the [creditors’] claim is a claim secured only by a security interest in real property that is [the debtor’s] principal residence . . . .”<sup>175</sup> Additionally, the *Addams* court determined that the principal-residence status should be determined as of the loan origination date.<sup>176</sup> Because there was no dispute that the subject property was used by the debtor as her principal residence at the time of the loan origination, the court prohibited the debtor from modifying the secured claim.<sup>177</sup>

A number of other courts have also adopted the Mixed-Use Approach in the post-BAPCPA and BTCA period.<sup>178</sup>

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172. *Id.* at 460.

173. *Id.* at 466.

174. *Id.*

175. *Id.* Note that the court might have found additional support for this conclusion in its finding that under New York law—the applicable state law—a security interest in rents represents an interest in real property, not personalty. *Id.*

176. *Id.*

177. *Id.*

178. *E.g.*, *In re Harriman*, No. 12-49371, 2014 WL 1312103, at \*4 (Bankr. N.D. Cal. Mar. 31, 2014) (adopting the third approach and stating that “the [*Wages* court’s] interpretation of the anti-modification provision is the most consistent and sensible reading of the statute.” (citing *In re Wages*, 508 B.R. 161, 168 (B.A.P. 9th Cir. 2014))); *In re Cady*, No. 3:14-BK-3817-PMG, 2015 WL 631359, at \*5 (Bankr. M.D. Fla. Jan. 27, 2015) (finding the subject property to constitute the debtor’s principal residence, even though the debtor simultaneously used the property as a home office for his work as a real estate agent); *Utzman v. Suntrust Mortg., Inc.*, No. 15-CV-04299-RS, 2016 WL 795739, at \*9 (N.D. Cal. Mar. 1, 2016) (holding that so long as the claim is secured only by real property that the debtor uses as principal residence, renting out a portion of the property to a third-party tenant does not remove the anti-modification protection); *In re Kelly*, No. CV 15-06419-DD, 2016 WL 2893984, at \*6 (Bankr. D.S.C. May 11, 2016) (“[I]f [real] property is the only collateral for a secured creditor’s claim and is used as the debtor’s principal residence, the mere fact that the property or a portion of the property is used for some other purpose does not preclude the application of the anti-modification provisions . . . .”); *In re Brooks*, 550 B.R. 19, 25 (Bankr. W.D.N.Y. 2016) (adopting the third approach and stating that while it might not be the majority rule, “it is an emerging view.”); *In re Hock*, 571 B.R. 891 (Bankr. S.D. Fla. 2017); *In re*

### III. PROPOSED RESOLUTION OF THE EMERGING SPLIT

Courts should adopt the Mixed-Use Approach. That is, courts should interpret the anti-modification provisions as currently enacted to prohibit modification of a mortgage on real property that is actually being used as the principal residence of the debtor, even if the debtor simultaneously uses the property for additional, including income-generating, purposes.

Support for the adoption of the Mixed-Use Approach lies primarily in the language of the relevant statutory definitions. As it is shown in the text that follows, the definition of “debtor’s principal residence” comprises of terms representing both real as well as personal property. Accordingly, case law equating the terms “real property” and “debtor’s principal residence” in the language of the anti-modification provisions in support of the Residential-Use-Only Approach should be rejected.

Further, the express language of the definitions anticipates that part of the principal residence of the debtor can be used for generating income. Thus, case law adopting the Residential-Use-Only Approach after concluding that the anti-modification provisions do not apply to any real property that is not used exclusively for residential purposes should be rejected as well.

The most recent amendments to the Bankruptcy Code relevant for the issue, the BAPCPA and the BTCA in particular, rendered the anti-modification provisions unambiguous. Therefore, decisions adopting either the Residential-Use-Only Approach or Case-by-Case Approach with reference to legislative history after finding the provisions ambiguous should no longer apply.

Even if a court would find the provisions ambiguous, however, the purpose of the provisions was to introduce certainty to the market with residential mortgages. Because I believe that such purpose is best served by the Mixed-Use Approach, the other approaches should be rejected.

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Wissel, 619 B.R. 299, 320 (Bankr. D.N.J. 2020) (prohibiting the debtors from modifying a mortgage on their real property in which they principally resided while simultaneously using the property to run two home businesses).

A. ADOPTION OF THE MIXED-USE APPROACH IS SUPPORTED BY  
THE UNAMBIGUOUS LANGUAGE OF THE ANTI-MODIFICATION PROVISIONS

Section 1322(b)(2) prohibits the debtor from modifying “the rights of holders of secured claims, *other than a claim secured only by a security interest in real property that is the debtor’s principal residence . . .*.”<sup>179</sup> The Bankruptcy Code defines what constitutes debtor’s principal residence through two separate definitions.

First, Section 101(13A) defines “debtor’s principal residence” as:

(A) mean[ing] a residential structure if used as the principal residence by the debtor, including *incidental property*, without regard to whether that structure is attached to real property; and

(B) includ[ing] an individual condominium or cooperative unit, a mobile or manufactured home, or trailer if used as the principal residence by the debtor.<sup>180</sup>

Second, Section 101(27B) further elaborates on that definition by separately defining “incidental property” to include, among others, “all easements, rights, appurtenances, fixtures, rents, royalties, mineral rights, oil or gas rights or profits, water rights, escrow funds, or insurance proceeds . . . .”<sup>181</sup>

In *Scarborough*, the Third Circuit equated the terms “real property” and “debtor’s principal residence” in the language of the anti-modification provisions.<sup>182</sup> That equivalency exists only when the subject property is used in its entirety solely as the debtor’s principal residence.<sup>183</sup> If, for example, part of the property is rented out, the equivalency is not satisfied because the property is being partly used to generate rental income.<sup>184</sup> With such property, the anti-modification

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179. 11 U.S.C. § 1322(b)(2) (emphasis added).

180. 11 U.S.C. § 101(13A) (emphasis added).

181. 11 U.S.C. § 101(27B)(B).

182. *In re Scarborough*, 461 F.3d 406, 411 (3d Cir. 2006).

183. *Id.* (stating that the anti-modification provisions protect “claims secured only by a security interest in real property that *is* the debtor’s principal residence, not real property that *includes* or *contains* the debtor’s principal residence, and not real property *on which the debtor resides*.” (quoting *In re Adebanjo*, 165 B.R. 98, 104 (Bankr. D. Conn. 1994)).

184. *Id.*

provisions do not apply, and a plan provision dependent on bifurcation of the mortgage is subject to confirmation.<sup>185</sup>

*Scarborough*'s analysis no longer applies under the current state of the Bankruptcy Code. *Scarborough* was decided pre-BAPCPA, before the Bankruptcy Code expressly defined "debtor's principal residence."<sup>186</sup> The BAPCPA enacted a definition of this phrase clarifying that a "residential structure" includes "incidental property."<sup>187</sup> Intuitively, the "residential structure" portion of the definition captures the "main" real property where a debtor's principal residence is primarily situated.<sup>188</sup> The "incidental property" portion, on the other hand, typically consists of non-residential assets that represent both real and personal property "without regard to whether [such assets are] attached to real property."<sup>189</sup>

The above becomes apparent upon a closer look at the definition of "incidental property." Some of the terms listed in sub-paragraph (B) of the definition, such as easements, fixtures, or rents may be considered, depending on the applicable non-bankruptcy law, real property.<sup>190</sup> Others, such as escrow funds or insurance proceeds will most commonly represent personal property.<sup>191</sup>

It follows that *Scarborough*'s logic of equating "real property" and "debtor's principal residence" no longer applies because the BAPCPA defined the latter term to include both real and personal property.<sup>192</sup> To this extent, *Scarborough* has been effectively overridden by Congress.

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185. *Id.*

186. *Id.* at 412 n.2. More precisely, *Scarborough* did not apply the BAPCPA due to its temporal scope. *Id.*

187. 11 U.S.C. § 101(13A)(A).

188. *See id.*

189. *Id.*; 11 U.S.C. § 101(27B); *see also In re Hock*, 571 B.R. 891, 895 (Bankr. S.D. Fla. 2017) ("[T]he definition contemplates that a debtor's principal residence may be a residential structure that the debtor uses as his principal residence plus incidental, non-residential property.").

190. *See* 11 U.S.C. § 101(27B)(B); *see also In re Addams*, 564 B.R. 458, 466 (Bankr. E.D.N.Y. 2017) (finding that "rents" represent real property under New York law).

191. *See* 11 U.S.C. § 101(27B)(B); *see also In re Bradsher*, 427 B.R. 386, 391 (Bankr. M.D.N.C. 2010) (finding that "escrow funds" represent personal property under North Carolina law); *In re Lunger*, 370 B.R. 649, 651 (Bankr. M.D. Pa. 2007) (reaching the same conclusion under Pennsylvania law).

192. *See* 11 U.S.C. § 101(27B)(B); *see also In re Wages*, 508 B.R. 161, 166 (B.A.P. 9th Cir. 2014) ("[T]he definition does not equate the term 'real property' with 'debtor's

Because the equating argument falls, nothing explicitly dictates that the subject property must be used exclusively as principal residence for the anti-modification provisions to apply. Accordingly, the provisions apply even if the debtor simultaneously uses the property for residential as well as other purposes—such as for generating rental income. In fact, the BTCA clarified in 2010 that the only requirement for the anti-modification protection to apply is that the subject-property is actually being “used as the principal residence by the debtor.”<sup>193</sup>

The same conclusion can be reached not only by rejecting the Third Circuit’s reasoning in *Scarborough*; it can also be positively deduced from the income-generating nature of the definition of incidental property. Some items listed in sub-paragraph (B) of the definition, such as mineral rights, oil or gas rights, or water rights typically represent legal entitlements that are inherent in the nature of the real property in question, and belong to the property owner regardless of whether she decides to monetize them or not.<sup>194</sup> Others, such as rents, escrow funds, or insurance proceeds are entitlements that only exist because they were bargained for by the property owner and the respective counterparty.<sup>195</sup>

This distinction is significant for the following reasons. The inclusion of the first group of items recognizes that while some debtors live in a dwelling located on a potentially income-generating land,<sup>196</sup> that by itself should not prevent the characterization of the property as the debtor’s principal residence. The second group reveals that debtors should be free to actively proceed with, for example, renting out part of their residence encumbered by a mortgage without removing the anti-

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principal residence.’ Therefore, an analysis which equates the two is misplaced.”); *Utzman v. Suntrust Mortg., Inc.*, No. 15-CV-04299-RS, 2016 WL 795739, at \*6 (N.D. Cal. Mar. 1, 2016) (“The[] changes [introduced by the BAPCPA] make clear Congress did not equate the terms ‘real property’ and ‘debtor’s principal residence.’”); *In re Wissel*, 619 B.R. 299, 313 (Bankr. D.N.J. 2020) (referring to the statutory definitions introduced by the BAPCPA, and stating that “[t]hese additions represent a clear Congressional statement that ‘real property’ and ‘debtor’s principal residence’ are no longer coterminous.”).

193. 11 U.S.C. § 101(13A)(A); Pub. L. No. 111-327, § 2(a)(1)(A), 124 Stat. 3557 (2010).

194. *See id.* Most commonly, these entitlements will represent in rem, or property rights.

195. *See id.* Most commonly, these entitlements will represent in personam, or contractual rights.

196. In this context, the income-generating potential of the land can stem, for example, from oils or minerals located on the property.

modification protection afforded to the respective creditors. Importantly, both groups have income-generating potential.

The income-generating nature of sub-paragraph (B) of the definition is further highlighted by the inclusion of “oil or gas rights or profits” among the constituents of incidental property.<sup>197</sup> The quoted text strongly indicates that a debtor need not merely hold rights to minerals, oil, gas, or other valuable commodities possibly located on the property passively. The debtor could actively engage in utilizing the rights and thereby generate profits. The debtor can do all of that without disturbing the principal-residence status of the subject property.

The above analysis can be tested on the following logic. For “rents” to exist, the property owner must rent at least part of the property that she uses as principal residence to a third party. From that moment on, the owner presumably generates rental income, and no longer uses the subject property exclusively as her principal residence. Nevertheless, the “rents” generated in this context are covered by the scope of “incidental property” which, in turn, is included in the definition of “debtor’s principal residence.”<sup>198</sup>

Accordingly, any analysis which concludes that the property loses its status as the debtor’s principal residence, simply by renting a portion of real property where the debtor resides, would effectively read “rents” out of the statute. There would be no use for it.

A number of recent decisions addressing multi-unit properties followed a substantially similar analysis.<sup>199</sup> Where the debtor did not

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197. 11 U.S.C. § 101(27B)(B).

198. 11 U.S.C. §§ 101(27B)(B), (13A)(A).

199. See e.g., *In re Addams*, 564 B.R. 458, 466 (Bankr. E.D.N.Y. 2017) (“Congress defined the debtor’s principal residence to include rents derived from the real property, and, as such, a security interest in rents is part of the security interest in the principal residence.”); *In re Hock*, 571 B.R. 891, 895 (Bankr. S.D. Fla. 2017) (stating that the statutory definitions contemplate that a debtor’s principal residence may include a residential structure as well as incidental, non-residential property); *Utzman v. Suntrust Mortg., Inc.*, No. 15-CV-04299, 2016 WL 795739, at \*9 (N.D. Cal. Mar. 1, 2016) (“[T]he fact that [the debtors] rent out a small portion of the property does not defeat the applicability of the [anti-modification protection].”); *In re Kelly*, No. CV 15-06419, 2016 WL 2893984, at \*4 (Bankr. D.S.C. May 11, 2016) (relying on the inclusion of “rents” in the definition of incidental property, and denying modification sought by the debtor even though the mortgage agreement contained an assignment of rents clause).



rent part of her principal residence to a third party but instead used it to run a home-business, recent courts have followed the same approach.<sup>200</sup>

The Bankruptcy Appellate Panel for the First Circuit in *In re Picchi* reached the opposite conclusion when it held that the anti-modification provisions do not bar bifurcation of a claim secured by a multi-unit dwelling.<sup>201</sup> As other courts did before, the court focused on whether the definition of “incidental property” could include a rental unit within a multi-unit dwelling.<sup>202</sup>

The *Picchi* court rejected the debtor’s argument that the phrase “property commonly conveyed with a principal residence in the area where the real property is located” in sub-paragraph (A) of the definition of incidental property can include a rental unit.<sup>203</sup> Instead, the court interpreted the phrase to cover only objects such as a boiler, attached garage, or window treatments.<sup>204</sup> While that reading is plausible, the court nowhere explained why a rental unit cannot be subsumed in sub-paragraph (B) of the same definition which expressly lists “rents.”<sup>205</sup>

Presumably, the *Picchi* court was focused on the fact that the definition nowhere expressly covers a rental unit within the debtor’s principal residence, and omitted that the rents derived from the same unit are expressly included.<sup>206</sup> Nevertheless, these are two sides of the

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200. See, e.g., *In re Wages*, 508 B.R. 161, 168 (B.A.P. 9th Cir. 2014) (denying modification of a mortgage on the debtors’ principal residence which the debtors used to operate their trucking business); *In re Cady*, No. 3:14-BK-3817, 2015 WL 631359, at \*1 (Bankr. M.D. Fla. Jan. 27, 2015) (denying modification even though the debtor simultaneously used the subject property as his principal residence and as a home office for his work as a real estate agent); *In re Wissel*, 619 B.R. 299, 320 (Bankr. D.N.J. 2020) (denying modification where the debtors allegedly used their principal residence to run an interior and exterior design business which generated nearly all of the debtors’ household income).

201. *In re Picchi*, 448 B.R. 870, 875 (B.A.P. 1st Cir. 2011).

202. *Id.*

203. *Id.*

204. *Id.*

205. 11 U.S.C. § 101(27B)(B).

206. To better understand the court’s position, it is worth mentioning that the court was bound by the First Circuit’s precedential holding in *Lomas. Picchi*, 448 B.R. at 872 (citing *Lomas Mortg., Inc. v. Louis*, 82 F.3d 1 (1st Cir. 1996)). As discussed above, before the enactment of the BAPCPA, the *Lomas* court found the anti-modification provisions ambiguous, and adopted the first interpretive approach by consulting the legislative history. See *Lomas*, 82 F.3d at 7. The *Picchi* court, in turn, focused on whether the ambiguity perceived by the First Circuit was removed by the statutory definitions introduced by the BAPCPA. The court held it was not. *Picchi*, 448 B.R. at 874.

same coin. There are no rents without a rental unit. Therefore, the Appellate Panel either purposefully ignored the inclusion of “rents” in sub-paragraph (B) of the definition, or effectively read the term out of the statute.

Some courts hold that if, in addition to a mortgage on real property itself, a creditor holds a security interest in an item included in the definition of incidental property, the inclusion alone does not mean that the anti-modification protection applies. According to these courts, whether or not the protection applies depends on the characterization of the particular item under the applicable state law. Only if the item represents real property, the protection applies.<sup>207</sup>

This question commonly arises where a creditor takes a security interest in escrow funds, in addition to a mortgage on the debtor’s residence. For example, the court in *In re Bradsher* found that because the creditor held a security interest both in real property and escrow funds, which were classified as personalty under state law, the anti-modification protection did not attach.<sup>208</sup> The court relied on the language of the anti-modification provisions, which requires that a security interest be held “only in real property” for the provisions to apply.<sup>209</sup>

That reading, however, ignores the language that follows and qualifies the type of real property that must be held. Only such real property that represents the debtor’s principal residence triggers the anti-modification protection.<sup>210</sup> Even if the applicable state law classifies rents, escrow funds, insurance proceeds, etc. as real property, these realties will inevitably be separate and distinct from the “main” real property in which the debtor’s principal residence is actually situated. Logically, a debtor cannot situate her principal residence in, for example, insurance proceeds or escrow funds.

Applying the reasoning of the *Bradsher* court to the above logic, a mortgage agreement that covers these additional items falls outside the anti-modification protection because such mortgage not only encumbers

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207. See e.g., *In re Bradsher*, 427 B.R. 386, 389 (Bankr. M.D.N.C. 2010); *In re Martin*, 444 B.R. 538, 543 (Bankr. M.D.N.C. 2011).

208. See *Bradsher*, 427 B.R. at 391–92 (finding escrow funds to constitute personal property under North Carolina law).

209. See *id.* at 387.

210. See 11 U.S.C. §§ 1123(b)(5), 1322(b)(2).

“real property that is the debtor’s principal residence,”<sup>211</sup> but also covers additional real property as well. Nevertheless, the court reached the exact opposite result.<sup>212</sup>

Worse, the above reading encourages inconsistent application of the anti-modification provisions. Different state laws will interpret “easements, rights, appurtenances, fixtures, rents, royalties, mineral rights, oil or gas rights or profits, water rights, escrow funds, or insurance proceeds”<sup>213</sup> differently.

This apparent inconsistency is best resolved by reading the anti-modification provisions as applying to any claim that is secured by a mortgage on real property that is actually being used by the debtor as her principal residence. That does not mean, however, that the real property must be the only collateral. The definition of the debtor’s principal residence expressly provides that it can be comprised of both: (i) a residential structure; and (ii) incidental property.<sup>214</sup> While the residential structure will presumably equate, both in legal classification as well as tangible nature, to the real property in question, incidental property can, and most commonly will, consist of property distinct from the main real property.<sup>215</sup>

State-law classification of the incidental property encumbered by the mortgage in question should be irrelevant. So long as the creditor takes a mortgage only on such real property that has the quality of being the debtor’s principal residence, the anti-modification protection applies. That some of the encumbered items covered by the definition of debtor’s principal residence are distinct from the main real property—

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211. 11 U.S.C. §§ 1123(b)(5), 1322(b)(2).

212. *See Bradsher*, 427 B.R. at 392.

213. 11 U.S.C. § 101(27B)(B).

214. *See* 11 U.S.C. § 101(13A)(A).

215. To illustrate how the terms “real property” and “debtor’s principal residence” fit and coexist together through the relevant statutory definitions, consider the following example: Think of a bottle of wine. The bottle represents real property, the wine is the principal residence. While the wine primarily resides in the bottle, the residential structure, it is not confined to the bottle. The wine can be poured into a glass or used to cook a delicious risotto. When wine leaves the bottle, however, it does not lose its status of principal residence. It simply relocates from its residential structure to find its new place in incidental property. In effect, the anti-modification provisions allow the owner of the bottle to pour herself a glass, while keeping the lender who financed the acquisition of, and took a security interest in, the bottle, protected from modification.

whether due to their legal status or (in)tangible nature—is of no import.<sup>216</sup>

A number of post-BAPCPA decisions reached the same conclusion. In *In re Lunger*, the court held that a home-mortgage lender's security interest in escrow funds did not remove the anti-modification protection even though escrow funds represented personal property under state law.<sup>217</sup> The court stated that “since Congress chose to define all ‘incidental property’ as included in the ‘debtor’s personal residence’ and all residences as being included in the term ‘real property,’ Congress has effectively broadened the definition of real property for the purposes of [the anti-modification provisions].”<sup>218</sup>

Other courts addressing escrow funds and other proceeds as additional collateral followed substantially the same reasoning.<sup>219</sup>

For example, in *In re LeBlanc*, the court denied modification of a mortgage secured, among others, by “[a]ll tenements, hereditaments, easements, appurtenances, rights, and privileges . . . including all rents, issues, and profits thereof”<sup>220</sup> and “[a]ll furniture, fixtures, and

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216. Intuitively, just about any item of the type included in the definition of incidental property cannot be provided as additional collateral. Only such escrow funds, rents, etc. that exist or are encumbered “with respect to a debtor’s principal residence” will qualify for incidental property that will not prevent the application of the anti-modification provisions. See 11 U.S.C. § 101(27B).

217. See *In re Lunger*, 370 B.R. 649, 651 (Bankr. M.D. Pa. 2007).

218. *Id.* While I agree with the *Lunger* court’s conclusion, I do not share its reasoning. As noted above, I consider the classification of the items included in the definition of incidental property irrelevant. I would not seek such classification under state law or, following *Lunger*’s reasoning, under the “[c]ongressionally broadened” definition of real property. Instead, it only matters whether a creditor took a mortgage only on such real property that is the debtor’s principal residence. Whatever additional property is encumbered with it is of no importance, so long as it falls under the umbrella of incidental property.

219. See, e.g., *In re Inglis*, 481 B.R. 480, 484 (Bankr. S.D. Ind. 2012) (addressing escrow funds); *In re Abdosh*, 513 B.R. 882, 886 (Bankr. D. Md. 2014) (referring to miscellaneous proceeds covered by the deed of trust and stating that even if the court were to consider them escrow funds, “the statute is clear that insurance proceeds and escrows are part and parcel of the [d]ebtors’ principal residence.”); *In re Birmingham*, 846 F.3d 88, 98 (4th Cir. 2017) (finding escrow funds, insurance proceeds, and miscellaneous proceeds covered by the deed of trust represent incidental property that does not bar the anti-modification protection, and stating that state law is suspended by federal bankruptcy law in the determination of the issue).

220. *In re LeBlanc*, No. 08-17239-BKC-AJC, 2009 WL 3378436, at \*2 (Bankr. S.D. Fla. July 22, 2009).

equipment . . .”<sup>221</sup> The mortgage agreement defined these groups of additional collateral as “appurtenances” and “fixtures” respectively.<sup>222</sup> The court had no difficulty concluding that since the definition of incidental property includes both appurtenances and fixtures covered by the mortgage agreement, the anti-modification protection applied.<sup>223</sup> Other courts that addressed similar types of collateral reached the same conclusion.<sup>224</sup>

For the above reasons, the language of the anti-modification provisions, when read together with the relevant statutory definitions, is unambiguous. The language plainly supports the adoption of the Mixed-Use Approach.

B. ADOPTION OF THE MIXED-USE APPROACH IS SUPPORTED BY  
THE PURPOSE OF THE ANTI-MODIFICATION PROVISIONS

Additionally, the Mixed-Use Approach and its effects are the most faithful to the very purpose of the anti-modification provisions. As Justice Stevens stated, “the legislative history indicat[ed] that favorable treatment of residential mortgagees was intended to encourage the flow of capital into the home lending market.”<sup>225</sup>

The Mixed-Use Approach encourages the flow of capital into the residential mortgage market by decreasing the credit risk faced by lenders and borrowing costs borne by borrowers. By decreasing the number of instances in which a debtor will be able to modify a claim secured by a mortgage on her principal residence, the risk of bifurcation of claims of under-secured creditors and the accompanying credit risk decline as well. This, in turn, allows lenders to conduct less due diligence or monitoring of the debtors’ use of their principal residences,

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221. *Id.*

222. *Id.*

223. *Id.* at \*3.

224. See e.g., *In re Shull*, 493 B.R. 453, 459 (Bankr. M.D. Pa. 2013) (finding that a security interest in fixtures granted to a home-mortgage lender constituted incidental property); *In re Wissel*, 619 B.R. 299, 317–18 (Bankr. D.N.J. 2020) (finding that improvements, easements, appurtenances, fixtures, escrow funds, replacements, and additions covered by the mortgage agreement all squarely fit within the scope of incidental property).

225. *Nobelman v. Am. Sav. Bank*, 508 U.S. 324, 332 (1993) (Stevens, J., concurring) (citing *Grubbs v. Hous. First Am. Sav. Ass’n.*, 730 F.2d 236, 245–46 (5th Cir. 1984)).

demand less restrictive covenants as to such use, and, ultimately, lower interest rates.<sup>226</sup>

The ultimate beneficiaries of this effect are consumers who are able to borrow at lower cost, or, in some instances, to actually borrow. Because of the ability to, for example, rent out part of the mortgaged property without the fear of breaching the relevant loan covenants, borrowers are once again more likely to borrow because now they have an additional source of income available to help them with servicing their debt.

Finally, this bright-line approach promotes efficiency and consistent application. Under the approach, there is no need to inquire into the notice of a lender of the mixed use by the borrower of the subject property. Even if the borrower, for example, rents out a portion of the property during the loan term, the anti-modification protection remains unaffected so long as the debtor uses the property as her principal residence. There is no need to argue over the relevant point in time at which the lender was supposedly put on notice either. Instead, the only determination a court must make is whether the property was actually being used by the debtor as her principal residence.

### CONCLUSION

Courts should adopt the Mixed-Use Approach because it most faithfully reflects the statutory language. Under the approach, the anti-modification provisions of the Bankruptcy Code prohibit a debtor from modifying a claim secured by a mortgage on real property so long as the

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226. See *In re Harriman*, No. 12-49371, 2014 WL 1312103, at \*2 (Bankr. N.D. Cal. Mar. 31, 2014) (referring to the creditor's statement that had it known of the debtor's intention to use the subject property for a commercial purpose, it would have subjected the proposed transaction to a heightened review and scrutiny, and imposed on the transaction higher interest rate and additional loan covenants); *Lomas Mortg., Inc. v. Louis*, 82 F.3d 1, 6 (1st Cir. 1996) (discussing how allowing modification of multi-unit residential properties would tend to harm home owners in urban areas, where multi-unit housing is more common, while favoring those purchasing single-family homes, more common in suburban areas, because of the higher interest rates lenders would apply on multi-unit loans to compensate for the higher risk of modification); *Utzman v. Suntrust Mortg., Inc.*, No. 15-CV-04299, 2016 WL 795739, at \*7 (N.D. Cal. Mar. 1, 2016) ("This bright-line approach also fosters certainty in the home lending market. Specifically, it counteracts the fear . . . that petitioners will sidestep the exemption by renting a portion of their property to another on the eve of their bankruptcy filing.").

debtor actually uses the property as the debtor's principal residence. Other simultaneous uses of the subject property, including income-generating ones, are irrelevant.

This conclusion is supported by the unambiguous text of the relevant statutory definitions. The definition of a debtor's principal residence expressly provides that a principal residence can consist of both residential structure and incidental property. The accompanying definition of incidental property covers such items as rents, escrow funds, insurance proceeds, or mineral, oil, or gas rights or profits.

It follows that debtors can actively proceed with renting a portion of their multi-unit dwellings in which they principally reside without compromising the principal-residence status of the property. Further, the overarching income-generating character of the definition of incidental property strongly suggests that debtors can generate income from or on their principal residences more generally—by, for example, running a home business. Moreover, the subject real property does not have to be the only collateral for the anti-modification protection to apply. It applies even if the underlying mortgage agreement covers collateral in addition to the “main” real property representing the debtor's principal residence, so long as the additional property is of the kind listed in the definition of incidental property. This conclusion should apply irrespective of the characterization of the additional incidental-property items of collateral under the applicable non-bankruptcy law as either personal or real property.

Finally, the adoption of the Mixed-Use Approach is further supported by the purpose of the anti-modification provisions of encouraging the flow of capital into the market with residential mortgages. The approach furthers that purpose by decreasing risk and costs to participants in residential mortgage transactions, and by promoting efficiency and consistent application.